This box contains the update to the Banco de España's macroeconomic projections for the Spanish economy published on 15 June,[1] including information that has become available since then. Specifically, the projections presented here incorporate the preliminary results of the Quarterly National Accounts for the second quarter of 2017, and the changes observed in the assumptions on which the projections are based (see Table 1).[2]

The current projections foresee the growth phase that began in late 2013 continuing over the period 2018-2020. This outlook for a continuation of the current economic expansion is supported by progress on correcting macro-financial imbalances. In particular, the economy's competitiveness gains have allowed the composition of GDP to be refocused from the demand-side perspective towards exports, making it possible for the expansion of activity and reduction of prevailing high levels of unemployment to be compatible with maintaining an external surplus. At the same time, private agents have been able to reconcile their spending plans with a reduction in their debt.

Against this positive backdrop, it is expected that the economy will continue to grow at above its potential rate, supported by the expansionary stance of demand-side policies, as reflected in the persistence of the accommodative monetary policy stance and, in the short term, the budgetary policy measures set out in the 2018 State Budget.

Nevertheless, it is expected that output growth will tend to moderate over the course of the projection horizon. From the standpoint of demand-side policies, the projected upturn in euro-area inflation resulting from the gradual widening of the output gap, reduces the likelihood of there being additional monetary stimulus, although the effects of the monetary policy measures implemented in recent years will continue to be felt. Additionally, the projection exercise assumes that the expansionary fiscal policy measures adopted in the first half of the year will support growth over the period 2018-2019, while in the absence of medium-term budgetary plans, fiscal policy is assumed to take a neutral stance in the final year of the projection. Lastly, the household saving rate is expected to recover from its current levels close to its all-time low, leading to

1 Macroeconomic projections for the Spanish economy (2018-2020): the Banco de España's contribution to the Eurosystem's June 2018 joint forecasting exercise.

2 The June publication was based on the information for the variables underlying the forecasts available as at 22 May. In the case of the current projections, the information referring to developments in Spain's export markets is that prepared by ECB staff for the publication of the ECB staff macroeconomic projections for the euro area, September 2018, for which the cut-off date was 21 August. For their part, the data on the remainder of the assumptions used in preparation of the projections were updated on 14 September. Finally, information available as at 21 September was used in the preparation of the projections. However, explicit use has not been made of the information in the revised Annual National Accounts published by the National Statistics Office (INE) on 6 September. The reason is that the models used to prepare the projections require quarterly series, and on the cut-off date for these projections quarterly series consistent with the latest annual information were not yet available.

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

		September 2018 projections			Difference between the current projections and those made in June 2018 (b)		
	2017	2018	2019	2020	2018	2019	2020
International environment							
World output	3.6	3.7	3.5	3.4	-0.1	-0.2	0.0
Spain's export markets	4.9	3.5	3.8	3.7	-0.9	-0.5	-0.1
Oil price in dollars/barrel (level)	54.4	73.4	75.5	71.9	-1.1	2.0	3.2
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.13	1.19	1.16	1.16	-0.01	-0.02	-0.02
Spain's nominal effective exchange rate vis-à-vis the world including the euro area (2000 = 100 and percentage differences) (c)	114.6	117.9	118.6	118.6	0.5	1.1	1.1
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.3	-0.2	0.1	0.0	-0.1	-0.2
Long-term interest rate (10-year bond yield) (d)	1.6	1.4	1.7	2.0	-0.1	-0.1	-0.1

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 14 September 2018. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.
b Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate, percentage differences for the effective nominal exchange rate and percentage point differences in the case of interest rates.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
d For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

a further moderation in consumer spending in addition to that seen since 2017. The short-term information available suggests that GDP growth in the third quarter may have been 0.6%, as in the second quarter. The slight growth moderation forecast for the following quarters would slow output growth from 2.6% in 2018 to 2.2% and 2% in each of the two following years.

Inflation is projected to follow a downward path in annual average HICP growth terms over the projection horizon, with rates of 1.8%, 1.7% and 1.5%, respectively, in each of the three years considered.[3] This downward trajectory of the headline indicator is mainly driven by the slowdown in the energy component, primarily explained by the downward oil futures curve. By contrast, the core inflation component is expected to pick up as the period in which output is expanding at above its trend rate continues and leads to ever higher capacity utilisation. Specifically, HICP excluding energy and food, is projected to rise by 1% this year, before accelerating to 1.4% and 1.8% in the following two years.

Overall, relative to the June projections, the changes in the assumptions underlying the forecast have a negative impact on activity and an approximately neutral impact on prices. The most significant change in the assumptions is the markedly less dynamic

3 Until recently, the benchmark variables used by the Directorate General Economics, Statistics and Research (DGEE) of the Banco de España to analyse and forecast the behaviour of consumer prices in Spain were the national definition of the consumer price index (CPI) and an index derived from it by excluding prices of energy and unprocessed food, as an accompanying measure of core inflation (IPSEBENE, by its Spanish abbreviation). The note "Reference variables for analysing inflation in Spain" explains why the DGEE opted to replace the previous measures by the Harmonised Index of Consumer Prices (HICP), as an overall measure of changes in consumer prices, and the indicator derived from it excluding energy and food prices, as a measure of changes in core inflation.

Table 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a)

Annual rate of change in volume terms and % of GDP

			September 2018 projections			Difference between the current projections and those made in June 2018		
	2017 (b)	2017	2018	2019	2020	2018	2019	2020
GDP	3.0	3.1	2.6	2.2	2.0	-0.1	-0.2	-0.1
Private consumption	2.5	2.4	2.2	1.6	1.5	-0.2	-0.2	-0.2
Government consumption	1.9	1.6	1.9	1.5	1.2	0.4	0.1	0.0
Gross fixed capital formation	4.8	5.0	5.1	4.1	3.9	0.8	-0.2	-0.1
Investment in capital goods	5.7	6.1	5.1	3.8	3.7	2.6	-0.4	-0.3
Investment in construction	4.6	4.6	5.5	4.4	4.3	-0.1	0.0	0.0
Exports of goods and services	5.2	5.0	2.6	3.9	4.1	-2.0	-0.9	-0.4
Imports of goods and services	5.6	4.7	3.1	4.0	4.0	-1.4	-0.6	-0.5
National demand (contribution to growth)	2.9	2.8	2.7	2.1	1.9	0.2	-0.1	-0.1
Net external demand (contribution to growth)	0.1	0.3	-0.1	0.1	0.1	-0.3	-0.1	0.0
Nominal GDP	4.3	4.0	3.7	3.9	3.8	-0.5	-0.2	-0.2
GDP deflator	1.2	1.0	1.0	1.7	1.8	-0.4	0.0	-0.1
Harmonised index of consumer prices (HICP)	2.0	2.0	1.8	1.7	1.5	-0.2	0.0	-0.1
HICP excluding energy and food	1.2	1.2	1.0	1.4	1.8	-0.4	-0.3	-0.2
Employment (full-time equivalents)	2.9	2.8	2.4	1.9	1.7	0.0	-0.2	-0.2
Unemployment rate (% of labour force). End-of-period data	16.5	16.5	14.6	13.2	11.9	0.0	0.2	0.5
Unemployment rate (% of labour force). Average data	17.2	17.2	15.3	13.8	12.4	0.1	0.4	0.6
Nation's net lending (+) / net borrowing (-) (% of GDP)	—	2.0	1.3	1.1	1.1	-0.3	-0.5	-0.4
General goverment's net lending (+) / net borrowing (-) (% of GDP)	—	-3.1	-2.8	-2.5	-2.2	-0.1	-0.2	-0.2

SOURCES: Banco de España and INE.
Latest QNA data: 2018 Q2.

a Projections cut-off date: 21 September 2018.
b The rates of change in 2017 that refer to the National Accounts series have been updated to include the revision of the Annnual National Accounts for the years 2015-2017 published by the INE on 6 September. The new figures for net lending / net borrowing of the nation and of the general government will be published on 28 September.

performance of export markets, with expected growth 1.5 pp lower in cumulative terms over the period 2018-2020 than was projected three months ago. This deterioration in the outlook for global trade and activity is more pronounced in the case of the more vulnerable emerging market economies, which have started to feel the effects of the uncertainty generated by the successive announcements of the introduction of protectionist measures, and also of the tightening financial conditions in these economies, resulting from the shift towards a less expansionary monetary policy stance in the United States.[4] Moreover, measured in euro, the oil price is now projected to be higher in 2019 and 2020, which also helps explain the weakening of the Spanish economy's momentum compared to the June projections. Conversely, the downward revision of short and long-term interest rates, in line with the expectations implicit in the yield curves, results in a slight cheapening of lending to households, according to the equations linking bank lending rates to these market rates.

There are only minor changes to the public finance assumptions over the projection horizon compared to the previous exercise. Fiscal policy projections for 2018 are based on measures adopted in the budgets of the various different tiers of government for this year,[5] together with the available information on their execution. As regards the assumptions for the remainder of the projection horizon, on the cut-off date for these projections, the draft 2019 State and Social Security budget had not been submitted. This being the case, we opted to use various technical assumptions to estimate the fiscal variables for the period 2019-2020. First, the impact of the measures approved in 2018, but with effects on the following years, was considered, such as the 2019 pension increase of 1.6% adopted in the 2018 State budget, the public sector employment and salary agreement between the government and main unions in the sector for the period 2018-2020, and the deferred effects of changes in personal income tax regulations. Second, it was assumed that those budgetary items subject to greater discretionality – such as public investment and procurement, in particular, given their volume – will grow in line with the nominal growth potential of the Spanish economy.[6] Finally, it was assumed that, in the absence of specific measures, the course of the remaining items in the general government accounts will be shaped by the usual factors.[7]

According to these assumptions and forecasts of the fiscal policy variables and the output gap estimated in a way consistent with the other macroeconomic projections, the fiscal policy stance is expected to be expansionary in 2018 and 2019, after its approximately neutral stance in 2017.

Current GDP growth projections entail downward revisions from the previous projection of 0.1 pp, 0.2 pp and 0.1 pp in 2018, 2019 and 2020, respectively. The scale of the revision is similar to that which, based on historical evidence, would derive from the impact of the changes in the various assumptions shaping the projection.[8] This is mainly a consequence of the worsening outlook for developments in Spain's export markets and, to a lesser extent, rising oil prices. By contrast, the further cut in the cost of borrowing by private agents exerts a slightly expansionary effect.

As in the case of GDP, the sign of the revision of the main demand components is also negative in cumulative terms over the projection horizon as a whole.[9] First, the worse expected performance of export markets translates into less buoyant exports. Also, the drop in external demand and the adverse effects of the increased uncertainty from the international environment on private agents' spending decisions have led to a slight downward revision of the main components of domestic demand. In turn, weaker final demand goes hand in hand with weaker imports.

Regarding inflation, the current projections for HICP growth represent a downward revision of 0.2 pp in 2018 and of 0.1 pp in 2020, while the annual average projected for 2019 remains unchanged. These relatively modest revisions are influenced by a combination of factors of opposite signs. Specifically, the energy component has been revised up over the entire projection horizon. In the near term, this is because, in recent months, energy prices have shown a more dynamic performance than was estimated in the previous projection exercise, while the higher energy goods inflation expected over the rest of the projection horizon is due to the higher expected levels of crude prices according to the futures markets. The projections for the core HICP component (which excludes energy and food prices) have been revised down as a result of the weaker demand momentum and the recent forecasting errors in this component, especially as regards services, which suggest that the response of inflation to the widening of the output gap could be more moderate than foreseen to date in the projections.

As has been the case since the start of the recovery, expenditure on consumer goods and services is expected to continue to be

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4 See Box 2 (Recent turbulence in emerging markets) in this edition of the Quarterly report on the Spanish economy.

5 For a detailed description, see Box 5 of the Quarterly report on the Spanish economy 2/2018 (June).

6 In a similar vein, the general government investment forecast for 2019 includes the estimate stated in the Stability Programme 2018-2021 of income in the order of €1 billion for the re-tendering of toll motorways that were taken under government management as a result of the bankruptcy proceedings this year.

7 Specifically, it is assumed that government revenue will grow in line with tax bases, which mainly depend on the macroeconomic context. Similar assumptions are made for those less discretionary expenditure items. This is the case of pensions (basically driven by population ageing and, in 2020, by the pension revaluation index, the revaluation formula established in the current legislation), unemployment benefits (which depend mainly on changes in the unemployment rate) and interest (which changes according to the level of government debt and interest rates).

8 Moreover, the preliminary Quarterly National Accounts (QNA) data for 2018 Q2 estimate the Spanish economy's output growth in the period to have been 0.6% in quarter-on-quarter terms. This is 0.1 pp lower than expected in the June projections, which also has a negative impact on the average GDP growth rate for the year as a whole.

9 Nevertheless, in the case of certain demand components (investment in capital goods, in particular), the preliminary estimate from the second quarter QNA was a positive surprise, with an automatic effect of the same sign on average annual growth rates in 2018, tending to offset the adverse impact of the new assumptions for this year.

underpinned by the favourable labour market performance, the steady improvement in households' financial wealth (assisted by the gradual deleveraging process) and the continued favourable financial conditions, in terms both of the availability and the cost of borrowed funds, reflected in the growing proportion of credit-based consumer spending.[10] In addition, especially in the near term, households' current expenditure will benefit from the positive effect on households' income of the entry into force of various budgetary measures contained in the State budget for 2018, such as the salary increase for public sector employees, the more dynamic employment performance in the general government sector or the decisions adopted on revaluation of pensions.

Nevertheless, private consumption is expected to decelerate over the projection horizon, as the result of a combination of a variety of factors. First, the projected slowdown in GDP will, naturally, be accompanied by slower employment generation. Second, although in terms of labour income growth the projected acceleration in real wages will tend to offset the lower employment momentum expected, the composition of that labour income growth over the projection horizon will tend to become less favourable to household expenditure than it was in the past, given that, on the evidence available, consumer spending tends to be less responsive when a given increase in labour income stems from rising real wages rather than from rising employment. Lastly, the reversal of some of the factors that have driven down the saving rate in recent years will also help to moderate the pace of growth of private consumption.[11]

Residential investment is set to continue to record high rates of growth, against a backdrop of continued highly favourable conditions for taking out mortgages. However, some deceleration in this demand component is expected over the projection horizon, since the strong pace of growth in the recent period, combined with the decline in the saving rate, has led to the emergence of household net borrowing (albeit on a small scale). In the projection period, the increase in saving and the lower momentum of residential investment will allow household net borrowing to stabilise around its current levels. Business investment will be encouraged by the plentiful generation of internal funds and the availability of low-cost funding, but this component will also decelerate somewhat, in keeping with the lower final demand momentum. In addition, the heightened uncertainty about the global economy will also tend to hold back non-financial corporations' investment decisions.

Sales of non-tourism goods and services to the rest of the world are expected to grow relatively moderately over the projection horizon, in keeping with the deterioration of the outlook for foreign markets. Nevertheless, exports of these products should continue to grow slightly faster than their destination markets, as a result of the increase in the number of firms which, once they have begun to export to a certain market, are able to continue to do so years later and to substantially increase the volumes sold. As for exports of tourism services, after the recent slowdown linked to the recovery of various alternative destinations and, to a lesser extent, to the signs of saturation in certain areas of Spain, rates of growth are expected to stabilise over the projection horizon.[12] Lastly, in the case of imports, it continues to be assumed that they will grow at a slightly slower pace than their historical relationship with final demand would warrant.

Employment will continue to record the high growth rates that are customary in upturns in the Spanish economy, allowing the unemployment rate to drop somewhat below 12% by the end of the projection horizon.

The economy's net lending position, which in 2017 amounted to 2% of GDP, will decline this year to around 1.3% and is expected to remain close to that figure over the rest of the projection horizon. This moderation in the external balance, concentrated on the balance of goods and services, would be as a result both of the deterioration observed this year in net trade flows in real terms and the deterioration in terms of trade, against a backdrop of rising oil prices. It is estimated that the budget deficit could amount to 2.8% of GDP this year, 0.1 pp more than envisaged in the June projections, given that the slowdown in activity in the final stretch of the year is expected to affect the strength of tax bases and, therefore, tax revenue. In subsequent years, under the assumptions described above and the favourable cyclical conditions, the budget deficit may be expected to experiment a further slight decline.

The current projections for consumer prices point to a gradual increase in core inflation, measured by the annual rate of change in the HICP excluding energy and food, from 1% in 2018 to 1.8% in 2020. This increase is consistent with the projected widening of the positive output gap, given that GDP is expected to grow above its potential rate throughout the projection period. From the cost standpoint, it is estimated that wage growth will tend to accelerate as labour market slack decreases and in line with the recommendations of the Employment and Collective Bargaining Agreement for 2018-2020 entered into by the social partners in June. This gradually increasing rate of growth in wages can be expected to pass through to unit labour costs, since no significant increase in productivity above its current low rates is expected over the projection period. In addition, it is estimated that profit margins (measured as the difference between the rates of growth of the GDP deflator and unit labour costs) will stabilise. External inflationary pressures, which have been high in 2018 as a result of higher oil prices, should moderate significantly in coming quarters, in keeping with the path of oil prices on the futures markets, an effect that will dominate the expected trajectory of consumer prices in the period. Overall, the HICP is expected to rise by 1.8% this year, peaking in Q3, before starting to decelerate, to reach 1.7% in 2019 and 1.5% in 2020.

10 See Box 7 (Recent developments in the consumer credit market in Spain) in this edition of the Quarterly report on the Spanish economy.

11 See Box 5 (The household saving rate in Spain: developments and outlook) in this edition of the Quarterly report on the Spanish economy.

12 See Box 6 (The slowdown in non-resident tourism in 2018 to date) in this edition of the Quarterly report on the Spanish economy.

The risks to the baseline scenario for growth in activity are on the downside. On the external front, two of the risks identified in previous projection exercises – the adverse repercussions of the US economic policy mix on global financial conditions and the application of trade protectionism measures – have started to materialise and have already had an impact on the baseline scenario, triggering a downward revision of the ECB staff projections for GDP growth worldwide and for the euro area and of the Banco de España's projections for the Spanish economy. However, it is still possible that these two elements may have a more negative impact in the future. Other external risk factors for the Spanish economy are a hypothetical "no deal" outcome from the ongoing negotiations between the United Kingdom and the European Union to establish the framework for their future relations and for the transition period, and also the possible resurgence of concerns regarding the future trajectory of Italian budgetary policy.

On the domestic front, there is still a high level of uncertainty regarding the future economic policy stance, in view of the current parliamentary fragmentation. In addition, a hypothetical increase in uncertainty associated with the tense political situation in Catalonia poses an added risk to economic growth, particularly in Catalonia itself.

The limited progress made to date in the necessary process of correcting the high level of public debt remains an important element of vulnerability. Against the present backdrop of fiscal policy uncertainty, it should be stressed that decisions on spending instruments and public revenue must be compatible with the need to reduce public debt and to create some headroom for the introduction of stabilising fiscal policy measures should the macroeconomic situation deteriorate. In addition, the instruments to be used to underpin the necessary fiscal consolidation process should minimise, insofar as possible, any potential adverse effects on economic growth.

Moreover, it is also necessary to reinstate a structural reform agenda, to boost the efficiency of the main factor and product markets. This agenda should have two main priorities: first, to correct aspects of the judicial and institutional framework that are sapping the Spanish economy's growth potential; and second, to preserve the regulatory measures that were introduced in response to the crisis, which have underpinned the strength of the recovery and have, via competitiveness gains, made it compatible with an external surplus and strong job creation.

The risks to inflation in the baseline scenario are slightly on the downside, as a consequence of a hypothetical materialisation of the risks of the same sign weighing on activity. By contrast, if any of the currently latent geopolitical conflicts were to intensify, the prices of imported goods, and especially of energy inputs, could rise, with the consequent upward impact on consumer prices.